No. 11834

In the United States
CIRCUIT COURT OF APPEALS
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Appellant,

v.

GRACE NEFF SPENCER, Executrix,
Appellee,

UNITED STATES OF AMERICA,
Interpleader-Appellant.

On Appeal from the District Court of the United States for the District of Oregon.

BRIEF OF APPELLEE

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INDEX

LIST OF CITATIONS

Page

Decisions

LIST OF CITATIONS (Cont.)

Law Review Articles

Statutes and Regulations

Rules of Court

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OPINION BELOW

The District Court wrote no opinion. Its finding of fact and conclusions of law (Tr. 67-82) are reported in 73 F. Supp. 657.

JURISDICTION

The taxpayer, C. B. Spencer, plaintiff below, paid the appellant, J. W. Maloney, the sum of $152,619.84 on account of his combined income and victory tax lia-

bility for the tax period beginning March 1, 1942, and ending February 29, 1944 (Tr. 78, par. XVIII).

On or about April 21, 1945, the taxpayer filed with said appellant a claim for refund within the time allowed by Section 322 of the Internal Revenue Code, as amended (28 U.S.C.A. Sec. 322), and in accordance with the provisions of said section and Section 3772 of the Internal Revenue Code, as amended (28 U.S.C.A. Sec. 3772), (Tr. 4, 6-42). This claim is in the sum of $93,-565.04, and is based on the ground that the taxpayer was entitled to a net operating loss carry-back due to certain losses sustained during the tax year ended February 28, 1945, under the provisions of Sections 23 (k) and 122 of the Internal Revenue Code, as amended.

After the filing of this claim for refund more than six months passed without the receipt of notice of allowance or disallowance by the Commissioner of Internal Revenue, whereupon the taxpayer within the time provided in Section 3772 of the Internal Revenue Code (28 U.S.C.A. Sec. 3772) and on October 27, 1945, filed his complaint in this cause in the District Court of the United States for the District of Oregon (Tr. 2 et seq.; 78, par. XIV) for the recovery of the amount of said claim.

Jurisdiction of this cause was conferred upon the District Court by Section 24 of the Judicial Code of the United States, as amended (28 U.S.C.A. Sec. 41 (5)), which section was in effect at the time the complaint was filed and judgment entered below.

The case was tried without a jury, and on June 24, 1947, the District Court made and entered judgment against said appellant (Tr. 83-84).

Notice of appeal was filed by appellants on September 19, 1947 (Tr. 85). Jurisdiction to review judgments of the District Court, in cases such as this, was conferred on this Court by Section 128 (a) of the Judicial Code of the United States, as amended (28 U.S.C.A. Sec. 225 (a)), which section was in effect at that time.

C. B. Spencer, plaintiff below, was dead when the notice of appeal was filed. A motion of the appellants to substitute the executrix of the Estate of C. B. Spencer, Deceased, as appellee herein was granted by this Court October 8, 1948.

QUESTION PRESENTED

At page 3 of their brief the appellants state the following as one of the questions determinative of the issue in this case:

> " . . . whether the taxpayer was engaged in a statutory trade or business regularly carried on by him by financing only his three wholly-owned and controlled cannery corporations during the taxable year, . . ."

Appellee makes no contention that the taxpayer's business was limited to financing, and the court did not find that it was.

STATUTES INVOLVED

These are set forth in the Appendix, *infra.*

STATEMENT

In restating the substance of finding No. VIII appellants at page 7 of their brief say:

> "The sums owed the taxpayer by those corporations were unpaid balances on open accounts receivable of the taxpayer [plaintiff below] and *not* open accounts payable of the corporations, . . ." (Italics inserted)

The italicized word "not" is obviously a misprint. The printed transcript gives the word as "no" (Tr. 72) and that is obviously a transposition of letters, although correctly copied from the findings signed by the trial judge. That the word "on" was intended rather than the word "no" is made abundantly clear from the findings taken as a whole, from the entire record and from the following quotation from page 18 of the appellants' brief:

> "The taxpayer made advancements to them [the two corporations] which were carried on their books as accounts payable to the taxpayer."

SUMMARY OF ARGUMENT

The taxpayer is entitled to carry back and deduct the net operating loss suffered in 1945.

It is the position of the taxpayer that he is entitled to carry back and deduct from gross income for the tax-

able period beginning March 1, 1942 and ending February 29, 1944 the net operating loss sustained in the taxable year ended February 28, 1945 under the provisions of Section 122 of the Internal Revenue Code. In order to come within the provisions of that section it is necessary for the taxpayer to sustain an excess of losses as measured by deductions allowable under Chapter One of the Internal Revenue Code. One such deduction is allowable in the case of a business bad debt (Sec. 23 (k) (1)).

The application of Section 23 (k) (1) is such that debts are allowable without limitation as deductions if they become worthless as an incident to the business of the taxpayer. The lower court in effect found that the business of the taxpayer was owning, developing and leasing packing plants and [and as an incident thereto] providing, through guarantee and otherwise, adequate financing of the leased plants. This providing of financing *was only incidental to the taxpayer's business of owning, developing and leasing of food processing plants,* as indicated by the provisions in the leases and the form of the findings themselves. The debts due the taxpayer with which we are concerned arose in his business of owning, developing and leasing plants, and when they became worthless he was still engaged in the same business. The obligations then, under any viewpoint, were obligations, the worthlessness of which was incurred in trade or business.

On the question of the character of the obligations themselves, the law is clear that the intent of the party

in making the advances governs. Where the taxpayer advances such funds with the thought of repayment and does not contemplate their investment as a permanent part of the business, his intent controls; and the advances are treated as loans. This should be particularly true in this case where the obligations of the debtors to the taxpayer arose only incidentally and as the result of a condition in the agreement whereby the taxpayer leased the plants he had acquired and equipped. Had the operations of the debtors been successful, their notes would have been paid; and it would be clear that the taxpayer had put no sums into the business.

This court has consistently applied Federal Rule of Civil Procedure 52 (a) to the effect that findings of a District Court in a non-jury case will not be set aside unless clearly erroneous. The findings of the lower court were to the effect that the taxpayer was in the business of "acquiring, owning, expanding, equipping, and leasing food processing plants. . ." As an incident of such business the taxpayer provided for the adequate financing of the operations of the leased plants. The burden of showing the findings to be erroneous is upon the appellants. While the appellants purport to object to those findings (Br. 5, fn. 3), they never once in their brief point out wherein the finding is erroneous as being unsupported by evidence. Instead, they have a mistaken conception of the incidental findings of fact, namely, that the taxpayer as a part of his business provided financing of the operations of the plants which he owned, developed and leased, and have assumed that financing was the only business in which the Court found that the taxpayer

was engaged. Obviously the owning, developing and leasing of the packing plants was the principal part of his business. As the appellants have not met the burden which the law imposes upon them, nor even contested the findings below, they must necessarily fail in their appeal.

ARGUMENT

A. Taxpayer was engaged in a business regularly carried on by him. The findings of the District Court shall not be set aside unless clearly erroneous.

The District Court in the trial of this case found as a fact that the taxpayer during the taxable years ended February 29, 1944 and February 28, 1945 "was engaged in the business of acquiring, owning, expanding, equipping, and leasing food processing plants and providing, through guarantee and otherwise, adequate financing of the operations of such plants; and the said business during said time was regularly carried on by the plaintiff for profit." (Tr. 68). In effect this is that the principal business of the taxpayer consisted of owning, developing and leasing packing plants, and that the adequate financing of plant operations was an incident of his business.

To avoid any question as to the extent to which providing financing was incidental, the pertinent provision contained in each cannery lease is set out below.

> "Financing: It is recognized that large sums of money will be required to finance the operations of LESSEE, and LESSORS hereby agree that when

> required they will provide (through personal guarantee and through the pledge of such of their property covered by this Lease as may be necessary) adequate financing for the needs of LESSEE, as a part of the services to be performed in consideration of the rental to be paid hereunder."

The Federal Rules of Civil Procedure, Section 52 (a), provide that in non-jury cases "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." Findings of fact will not be disturbed by an appellate court when supported by substantial evidence, *Brodie Co. v. Hydraulic Press Mfg. Co.,* 151 F. 2d 91 (C.C.A. 9th, 1945); or by competent evidence of probative character, *Lincoln Nat. Life Ins. Co. v. Mathisen,* 150 F. 2d 292 (C.C.A. 9th, 1945); and such findings are presumptively correct unless "some obvious error of law, or mistake of fact has intervened", *Wittmayer v. United States,* 118 F. 2d 808 (C.C.A. 9th, 1941). Of similar import are *Universal Pictures Co. v. Cummings,* 150 F. 2d 986 (C.C.A. 9th, 1945); *Stimson v. Tarrant,* 132 F. 2d 363 (C.C.A. 9th, 1943); *Matson Navigation Co. v. Hansen,* 132 F. 2d 487 (C.C.A. 9th, 1942); *Gates v. General Casualty Co.,* 120 F. 2d 925 (C.C.A. 9th, 1941).

At page 16 of their brief, appellants say:

> ". . . in order to prevail, it is incumbent upon the taxpayer to establish (a) that his activities in financing and guaranteeing the obligations of only his three wholly-owned and controlled cannery corporations during the taxable year constituted 'the operation of a trade or business regularly carried on' by him, . . ."

This is inaccurate in two respects. First, it is not incumbent upon the appellee to establish that taxpayer was in the business described in quotation, as we shall hereinafter show. Second, on this appeal, the burden of establishing that the findings of the lower court are clearly erroneous, not supported by substantial evidence, and the result of mistake of law or fact is upon the appellants. *Augustine v. Bowles,* 149 F. 2d 93 (C.C.A. 9th, 1945).

APPELLANTS FAIL TO SUSTAIN BURDEN

It is submitted at the outset of this argument that the appellants have not sustained the burden which the law casts on them. Instead they have chosen to side-step the main issue of the case and substitute another for it. The findings of the lower court are clear. They state what the business of the taxpayer was. Nevertheless, the appellants in their brief have disregarded the findings of fact of the lower court and have argued the case on the theory that the court found the taxpayer was engaged only in the "business of financing canneries" (Br. 18; Also 5, fn. 3; 11; 16; 19; 22). The court did not make such a finding. The language of the lower court makes it clear that providing financing was merely a necessary consequence of the main business of the taxpayer, which consisted of owning, developing and leasing canneries. In any event, it cannot be argued that the court found that the taxpayer's business consisted *only* of financing canneries or, in the language of the court, of providing "adequate financing".

The court found, and there is no argument to the contrary, that the leasing of canneries was embraced in the operation of the taxpayer's business. Had the court restricted its findings to this single point of leasing, such findings would have qualified the taxpayer for the deduction and carry-back.

The gist of the appellants' contention is that the taxpayer was engaged in no trade or business, yet he does not contest the finding of the court that the taxpayer was engaged in the business of "acquiring, owning, expanding, equipping and leasing food processing plants. . . ." In fact, this was the principal business of the taxpayer. Whether the taxpayer was engaged in the business of financing canneries (or of providing financing) is of little importance. As is shown infra, pp. 29-35, it is necessary only that the financing resulted in a loss which bears a visible *relation* to the business of the taxpayer. They need not themselves be *the* business. Determination of this *relation* is primarily a factual matter. In *Commissioner v. Heininger,* 320 U.S. 467 (1943), the Court said:

> "Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances."

The appellants have set up a straw man as a finding and have proceeded to challenge it, but have not attempted to question the actual findings. The findings of the lower court must stand since they are supported by an ample amount of competent evidence. It is submitted

that, since appellants place their main reliance for reversal upon the fact that the taxpayer was engaged in no business, the appellants' case fails *a priori,* and the judgment of the lower court should be upheld.

TRADE OR BUSINESS: A QUESTION OF FACT

Although the burden on this appeal lies with the appellants, it may prove useful to examine several of the cases dealing with the meaning of trade or business. The appellants urge that what constitutes a trade or business necessarily involves a conclusion (Br. 22-23), but it appears that this involves a conclusion of fact. In *Richards v. Commissioner,* 81 F. 2d 369 (C.C.A. 9th, 1936), this court said:

> "The Commissioner contends that the real property in question was not a capital asset, and the issue presented to the Board was whether or not the real property was 'held by the taxpayer primarily for sale in the course of his trade or business'. The determination of this issue is the ultimate fact."

See also *Winnett v. Helvering,* 68 F. 2d 614 (C.C.A. 9th, 1934); *Tricou v. Helvering,* 68 F. 2d 280 (C.C.A. 9th, 1933). In *Cecil v. Commissioner,* 100 F. 2d 896 (C.C.A. 4th, 1939), the court stated:

> "The term 'business' as here used was evidently not intended to have a technical meaning but to be understood in its ordinary acceptation."

And in *Kales v. Commissioner,* 101 F. 2d 35 (C.C.A. 6th, 1939), in deciding whether certain expenses arose from carrying on a business the court remarked:

> "Where statutory standards are lacking, it may, we think be here said . . . that 'language is to be read in its natural and common meaning'."

In the light of these decisions the appellants' statement at page 22 of their brief that the District Court used the language of the statute in finding that the business in which the taxpayer was engaged was "regularly carried on by him" and their accompanying criticism of that is without substance. As a matter of fact the court's finding was "and that said business was regularly carried on by the plaintiff for profit" (Tr. 68). That is merely the statement of an ultimate fact. The statute does not use the words "for profit" (28 U.S.C.A. Sec. 122 (d) (5)). Appellee submits it is proper to use the words of the statute in stating a conclusion of law as was done in Conclusion No. II (Tr. 27).[1]

The conclusion of law to be drawn is whether the business as found to exist is one of which the tax statutes take cognizance. As was stated in the leading case of *Higgins v. Commissioner,* 312 U.S. 212 (1941):

> "To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."

The Court stressed this point again in *United States v. Pyne,* 313 U.S. 127 (1941), and reversed the Court of Claims because that court had found only that the activities in question had been substantially the same as those

[1]It should be noted that at page 22 of their brief, as at other places therein, appellants disregard what the court found to be the business of the taxpayer and assert that the finding was "that the taxpayer was engaged in the business of cannery financing."

of a predecessor who had been a "financier and investor". The decision, then, was principally the result of the "Failure of the Court of Claims to make a specific finding on this ultimate and determinative issue", i.e., that the taxpayer himself was carrying on a trade or business. Thus, it becomes apparent that the trier of fact, after viewing all the evidence presented, must determine whether or not a business has been conducted, and his determination is primarily one of fact. The standard is a broad one that varies with each case and circumstance. See note 41 Col. L. Rev. 757 (1941).

THE TEST OF FREQUENCY AND CONTINUITY

An important guide used by courts in ascertaining whether operations constitute a business within the contemplation of the Internal Revenue Code is whether or not there was visible activity as opposed to mere passivity. Where entrepreneurial activity is found the courts have uniformly held that such business exists.

In *Commissioner v. Boeing,* 106 F. 2d 305 (C.C.A. 9th, 1939), this court said:

> "From the cases it would appear that the facts necessary to create the status of one engaged in a 'trade or business' revolve largely around the *frequency* or *continuity* of the transactions claimed to result in a 'business' status." (Italics inserted)

The court there held that the taxpayer who had contracted with certain parties to log off and sell the timber on lands owned by him was engaged in business for the

purpose of the tax statutes. This same rule was followed in *Ehrman v. Commissioner,* 120 F. 2d 607 (C.C.A. 9th, 1941), where the court sustained the finding of the Board of Tax Appeals that the taxpayers were engaged in the business of subdividing and selling real estate. In *Daily Journal Co. v. Commissioner,* 135 F. 2d 687 (C.C.A. 9th, 1943), the court in sustaining the deductions taken by the taxpayer stated that:

> "Petitioner's managerial activities in Consolidated were 'Extensive, varied, continuous, and regular'."

This same language as a basis of decision is found in *Miller v. Commissioner,* 102 F. 2d 476 (C.C.A. 9th, 1939), and *Kales v. Commissioner,* 101 F. 2d 35 (C.C.A. 6th, 1939). In *Foss v. Commissioner,* 75 F. 2d 326 (C.C.A. 1st, 1935), the court in sustaining a deduction for lawyer's fees remarked:

> "The line comes between those who take the position of passive investors, doing only what is necessary from an investment point of view, and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business."

In *Dalton v. Bowers,* 287 U.S. 404 (1932), the Court disallowed a claimed loss due to the worthlessness of stock of a corporation held by the taxpayer. As appellants have pointed out in their brief (Br. 27), this was because the taxpayer "was not *regularly* engaged in the business of buying and selling corporate stocks". (Italics inserted). The situation represented an isolated transaction. It should be noted also that the taxpayer in the

case at bar is claiming no deduction for the worthlessness of stock. His business did not involve stock or bond transactions. As is frequent in stock loss cases, the *Dalton* case involves problems difficult to determine and not present in the instant case, consequently the *Dalton* case is of no practical value in deciding the present case other than focusing attention on the fact that in the *Dalton* case the court was dealing with an isolated transaction.

Likewise, in *Burnet v. Clark,* 287 U.S. 410 (1932), the Court refused a claim for losses resulting from the indorsement of a corporation's notes because as the Court stated (quoted in appellants' brief p. 24-25):

> "Aside from endorsing an undisclosed number of notes of this company there is nothing in the record to indicate that acting as endorser or guarantor constituted a business or trade with the petitioner. So far as the record shows these were the only notes ever endorsed by the petitioner for the Bowers Company or for any other company or person. From the facts in the case we are of the opinion that the loss did not result from the operation of a trade or business *regularly* carried on by the petitioner but resulted from *isolated* or *occasional* transactions." (Italics inserted)

The Court also remarked:

> "He was not *regularly* engaged in endorsing notes, or buying and selling corporate securities. The unfortunate indorsements were no part of his ordinary business, but *occasional* transactions intended to preserve the value of his investment in capital shares." (Italics inserted)

It is only necessary to point out that it was not the in-

dorsing of the notes by the taxpayer in the case at bar which constituted his business. Rather it was the owning, acquiring, expanding, equipping and leasing which constituted the clearly defined planes of his business. His indorsements or guarantees were merely incidental to that business.

The findings of fact and the record speak for themselves in saying that the business of the taxpayer was extensive, regular and continuous. He owned, acquired, expanded, equipped and leased canneries, not to mention the providing of financing which he undertook as an incident thereto. The taxpayer testified that he acquired and leased canneries; that after acquiring them he had to enlarge them and build additional buildings, buy new equipment and see that the plants were kept in operating condition, and that in pursuit of these duties he had to travel from Portland to Albany, from Lebanon to Portland, from Yakima to Seattle, to Washington, D. C.; that the value of the additions he made to the plants was over a $100,000.00; that the additions were made during the time he was renting the plants to the corporations; that his business activities required about one-third of his time and required weekly attention (Tr. 120-124). There would, of course, be costs in acquiring the plants before he undertook to lease them, the amounts of which are not mentioned in the testimony. Mr. Bingham Powell, taxpayer's son-in-law and secretary-treasurer of each of the three leased food processing plants, testified that the taxpayer engaged in all the activities which were necessitated in enlarging, expand-

ing and improving the various plants which he was leasing to the corporations, which meant construction of buildings, the purchasing of materials and machinery, the arrangement and redesigning of existing plants and that the machines and plants were owned by the taxpayer and were on the leases with the canneries, that the taxpayer spent from 30 to 40 per cent of his time in doing these things and that the value of the additions he made to the plants was better than $100,000.00 (Tr. 178, 192, 193).

THE PROFIT TEST

In determining what constitutes carrying on a business a frequently used criterion is whether or not the taxpayer was engaged in the particular activity for profit, rather than as a hobby, or for pleasure. In *Tatt v. Commissioner,* 166 F. 2d 697 (C.C.A. 5th, 1948), the taxpayer had operated a farm with the idea of raising a part of the commodities sold in his main business of selling produce. His operations were unsuccessful, and losses resulted. The court allowed the deductions claimed because the farm had been operated for profit rather than for pleasure and was therefore a business. This same principal has been followed in numerous cases: *Wallace's Estate v. Commissioner,* 101 F. 2d 604 (C.C.A. 4th, 1939), in which the executrix of her husband's estate was held to be engaged in business for purposes of taking a deduction from taxes; in *Cecil v. Commissioner,* 100 F. 2d 896 (C.C.A. 4th, 1939), the operation of the famed Biltmore Estate in North Carolina as a museum

and park was held to be business within the meaning of the statute; *Richards v. Commissioner,* 81 F. 2d 369 (C.C.A. 9th, 1936), was a case in which lots of the taxpayer were held primarily for sale in the course of his business; *Whitney v. Commissioner,* 73 F. 2d 589 (C.C.A. 3d, 1934), where it was held that a racing stable was operated as a business for profit rather than for pleasure; *Commissioner v. Field,* 67 F. 2d 876 (C.C.A. 2d, 1933), held that in operating a farm and racing stable, the taxpayer, whose principal occupation was banking, was engaged in a business within the purview of the statute; *Doggett v. Burnet,* 65 F. 2d 191 (App. D.C., 1933), held that the publication and marketing of the works of an English religious teacher constituted a business, the court saying:

> "The proper test is . . . whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion."

These cases also state that whether the activity is entered into for profit is primarily a matter of intent.

That the activities of the taxpayer conform to this test is readily apparent. They were clearly undertaken for compensation, namely rent from the leasing of the plants (Tr. 124). The court found he was engaged in business "for profit" (Tr. 68).

Finally, it must be observed that the notion of profit upon which the courts rely is to be distinguished from the mere opportunity for gain, and that it includes de-

cision making (or risk taking) functions *other* than those which inhere in the mere investment of capital through stock purchases. Thus in *Deputy v. duPont,* 308 U.S. 488 (1940), the Court refused to sanction certain deductions as ordinary and necessary expenses incurred in carrying on a business because the original business decision that had given rise to the expenses claimed had been the decision of the *corporation* in which the taxpayer had been a stockholder and had not been *his own.* The taxpayer had undertaken the particular transactions only after the corporation had found certain difficulties of both a legal (ultra vires) and financial nature in the way of its carrying out the transactions. In the case now before the court for decision the obligations which the taxpayer undertook to guarantee were a deliberate and articulate part of the transactions first entered into *by the taxpayer* whereby *he* leased the plants as part of *his* business as found by the District Court.

It is also incumbent upon the appellee to correct what appears to be a discrepancy in the reporting of the above case by the appellants in their brief (p. 28). The appellants state that the deduction was disallowed "on the ground that the taxpayer was not engaged in the business of trading in securities". It is submitted that the court made no such decision. It even granted *arguendo* that the taxpayer was engaged in a trade or business, saying:

> "But as we view the case it is unnecessary for us to pass on that contention and to make the delicate

dissection of administrative practice which that would entail. For we are of the opinion that the deductions are not permitted . . . even though we were to assume that the activities of respondent constituted a business, as found by the District Court."

In *Deputy v. duPont* Justice Frankfurter wrote a concurring opinion from which the appellants on page 29 of their brief made the following quotation:

> " 'carrying on any trade or business,' within the contemplation of Section 23 (a), involves holding one's self out to others as engaged in the selling of goods or services. . . ."

It would appear from a reading of the appellants' brief that the essence of their argument is based on the idea embraced in the quotation, for they repeat, in one way or another, the observation that the taxpayer financed and guaranteed only the operations and obligations of his three canneries, not those of other canneries or corporations generally (Br. 14, 18, 19, 33). Justice Frankfurter's opinion obviously does not amount to an expression of the Supreme Court and no notice of it was taken in the subsequently decided *Higgins* case, *supra,* and so far as appellee has been able to discover, no notice has been taken of that statement in any other Supreme Court case. In *Daily Journal Co. v. Commissioner, supra,* this Court cited the *duPont* case and quoted a portion of the foregoing statement of Justice Frankfurter. The *Daily Journal Co.* case shows that Justice Frankfurter's definition is to be applied in a broad and reasonable manner, as this court in that case gave

weight to its former opinion in the case of *Miller v. Commissioner, supra.* It is also worthy of note at this point that this court distinguished the investment activities of the taxpayer in *Higgins v. Commissioner, supra,* from the situation confronting the court in *Daily Journal Co., supra.*

Immediately following their quotation from Justice Frankfurter, appellants say:

> "To the same effect, see *Van Dyke v. Commissioner,* 23 B.T.A. 946, . . . also *Watson v. Commissioner,* 124 F. 2d 437, 439 (C.C.A. 2d) . . . *Stephenson v. Commissioner,* 101 F. 2d 33 (C.C.A. 6th), . . . and *Gruver v. Helvering,* 70 F. 2d 292 (App. D.C.)."

None of those cases contain language in any way similar to that of Justice Frankfurter. The language "To the same effect" undoubtedly refers to the *Dalton* and *Burnet* cases, *supra.* A reading of the four cases mentioned in the quotation clearly shows that their facts are not like those of the case at bar. The appellee does not contend that the business of the taxpayer and the three corporations was the same. She does not seek to disregard the corporate entities. She does not claim the taxpayer was solely in the financing business. Her contention is that such financing as was provided by the taxpayer was incidental to his primary business of acquiring, owning, expanding, equipping and leasing of food processing plants.

SIMILAR CASES

Finally, there should be noted the similarity between the instant case and the other decisions. In *Kittredge v. Commissioner,* 88 F. 2d 632 (C.C.A. 2d, 1937), the question of an allowance of depreciation on property used in trade or business was before the court. The taxpayer in that case was the owner of only *two* wineries which he leased. The court upheld the contention that these were properties used in trade or business, saying:

> "Obviously, the petitioner was engaged in the winery business during the years in question, for he was operating through lessees other winery properties in California. Equally obvious is it that the Weston Winery was used in his business while a tenant was operating it on shares as a grape juice plant until early in 1922."

On pages 30 and 31 of their brief appellants have attempted to criticize or distinguish the cases of *Kittredge v. Commissioner, supra; Glenn M. Averill,* 20 B.T.A. 1196 (1930), and *Edwin H. Conrades,* 21 B.T.A. 213 (1930), which were cited and relied upon by the taxpayer in the lower court. We submit that the *Kittredge* case, *supra,* is in point because it shows that the leasing of property constitutes doing business within the meaning of Section 23 (k) of the Revenue Act of 1928, which permitted as a deduction:

> "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. . ."

The *Averill* case, *supra,* teaches that it is not necessary that the taxpayer should sustain the loss in his prin-

cipal business or vocation, and that he is entitled to business loss deductions if the loss is incurred in any trade or business regularly carried on by him. The *Conrades* case, *supra,* was cited by the taxpayer primarily for the purpose of showing that it is permissible under the Revenue Acts for a person engaged in business to limit the field of his activities if he chooses to do so. In this case the court said:

> "The fact that petitioner limited the field of his loans to corporations directed by him and individual associates with whose affairs and financial standing he was familiar, does not alter the fact that in making these loans he was carrying on a personal business distinct from the business carried on by the corporations in question. There is nothing in our opinion peculiar or significant in such limitation. . ."

In *George S. Jephson,* 37 B.T.A. 1117 (1938), the taxpayer, a manufacturer of food products, bought a house for the purpose of renting it. Although he listed it with a broker and took other steps, he was unable to rent it. The Board held that he was in business for the purpose of taking a depreciation deduction, saying at page 1119:

> "He had no purpose to occupy the property as his own residence and never in fact did occupy it. Thus it can fairly be said that he was carrying on a business, albeit without actual profit during the years in question. Obviously the inability to rent or sell the property at a profit during the taxable years does not take from the venture its business character, nor does the fact that the petitioner was not devoting his full time to a real estate business."

Cases quite close to the *Jephson* decision are too numerous to cite. Typical is *Leland Hazard,* 7 T.C. 372 (1946).

COMMENTS ON STATEMENTS AND ARGUMENTS OF APPELLANTS

At several places in their brief appellants have restated findings of the court in which the terms "such business" and "such business regularly carried on by the taxpayer" were used, and then objected to them on the theory that the terms referred to a finding by the court that the taxpayer's only business was "financing canneries". As we have pointed out the court made no such finding, and the terms "such business" and "such business regularly carried on by the taxpayer" as used in the findings means the taxpayer's business of owning, developing and leasing canneries and as an incident thereto providing financing for the operation of leased plants.

On page 19 of their brief, appellants say:

> ". . . the District Court's ultimate finding and conclusion that the taxpayer was engaged in the business of financing and guaranteeing the obligations of cannery corporations, generally, . . . find no support in the undisputed facts and the evidence of record, or in the statute and controlling decisions."

The court made no such finding. At the bottom of page 11 of their brief, appellants say:

> "Upon the basis of the foregoing facts the District Court held that the taxpayer was engaged in the business regularly carried on by him of guaranteeing the operations of his three wholly-owned corporations during the taxable years 1944 and 1945, . . ."

The court made no such holding, as is obvious from an examination of its Conclusions I through X (Tr. 79-82).

At the bottom on page 13 of appellants' brief they say that the District Court's findings and conclusions to the effect that the taxpayer's losses were "attributable to the operation of a trade or business regularly carried on by taxpayer" are directly opposed to the undisputed facts which show that the taxpayer was not engaged in such business, generally. Appellee has already pointed out that the court's findings are amply supported by the facts. Disregarding the taxpayer's business as actually found by the court, appellants near the top of page 14 of their brief advance the following argument:

> "The taxpayer, the sole stockholder of his three cannery corporations, financed and guaranteed only their operations and obligations, respectively, not those of other canneries or corporations generally. Therefore, he was not engaged in carrying on such business regularly."

It is not clear to what the term "such business" in the last sentence of the quotation refers. If it refers only to the first sentence of the quotation, the second sentence is unsound because it disregards most of the facts in the case. If, however, it refers to the type of business mentioned in the first sentence of the paragraph, which is at the bottom of page 13 of appellants' brief, it is completely illogical for the same reason. The conclusion of the argument constitutes a *non sequitur*. Appellee makes no contention that the taxpayer's business was that of financing and guaranteeing the operations and obligations of other canneries or corporations generally, and as we show it is not necessary that he should have done so in order to recover in this case.

At page 19 of their brief, appellants say that taxpayer financed "his own three cannery corporations, . . . in order 'to protect' his stock in those corporations (R. 157-158)". An examination of the cited pages of the record shows that on cross examination counsel used the term "to protect" in questioning the taxpayer. But he did not testify as the appellants' brief indicates.

Appellants' reluctance to meet the real issue in this case is well illustrated by the opening sentence of their argument beginning on page 17 of their brief. What has already been said amply shows what the taxpayer's business was.

Appellee dislikes taking issue with every little inaccuracy in the appellants' brief. Many have been passed by without comment. There are, however, three or four more that we feel should be mentioned.

On page 20 of appellants' brief, it is stated:

> ". . . the taxpayer, as sole stockholder, expanded his credit and invested the money by financing the three cannery enterprises (R. 123), which were wholly without assets or capital otherwise (R. 105, 161), . . . and that when they turned out to be unprofitable enterprises . . . he 'sold out' the canneries and took the losses (R. 104, 158-159, 160-161)."

Page 123 of the transcript does not show that taxpayer engaged in financing "as sole stockholder". On the contrary that page virtually shows he did it as owner or lessor, and the leases, which are the best evidence, show that taxpayer provided the financing as lessor. The corporations were not wholly without assets until after they

were liquidated. On page 105 taxpayer's counsel said that after February 15, 1945, "that corporation was wholly without assets". That was the date the corporation was liquidated. Before that they had the leases and the growers' contracts. These were valuable assets. Plants and machinery were extremely difficult to acquire during the war. The taxpayer testified that a new corporation or cannery could not go into business without growers' contracts, as a cannery must have raw products on which to work, and that contracts furnished them with a supply (Tr. 146), that the growers' contracts turned over to the Yakima corporation were of a value considerably in excess of $10,000.00, and that those turned over to the Dehydrator corporation in exchange for its capital stock were in excess of $5,000.00 (Tr. 147). After the corporations were in operation they also acquired other assets (Tr. 104, 106, 107). It is true that on page 161 the taxpayer testified as follows:

> "Q. They did not have assets for that purpose [money to start operating (Tr. 160)] when they were incorporated?
> A. That is right."

This question and answer, however, in the light of all the other testimony and evidence in the case does not justify the statement that the corporations "were wholly without assets or capital". On pages 161 and 162 of the transcript the taxpayer testified that he started his original plant in Lebanon on the same basis. That was in 1935 (Tr. 116). It was financially successful as indicated by the tax return (Tr. 14). Furthermore, a separate enterprise, that of the Lebanon corporation, one

of the corporations involved in this case, was started in the same way (Tr. 160, 161), and it continued to operate after the other two of the three corporations were liquidated (Tr. 119). The history of American business is replete with successful enterprises that started with borrowed working capital. The reasons for the failure of the Yakima corporation and the Dehydrator corporation were not the lack of working capital, but inexperienced help, labor shortages, continued change in specification by the Government, inexperienced inspectors, high prices for raw materials, controlled prices for finished products, and loss of market for the product (Tr. 125, 141, 194, 195). The manner in which the appellants, in the last quotation, stated " 'sold out' the canneries and took the loss" would indicate that the taxpayer so testified, but an examination of the cited pages of the transcript shows that the appellants added the words "and took the losses" to the taxpayer's testimony.

Appellee is at a loss to understand what the appellants mean by the words "as requested" in the third line after the quotation on page 22 of their brief. As far as the record shows they requested no findings or conclusions.

At pages 9 and 10 of their brief, appellants say:

> "The taxpayer's gross income from his business for the taxable year 1945 was $33,562.28. He took business deductions for that year in the sum of $17,-217.72, about which there is no dispute. This amount, together with the above two bad debts of $95,081.48, taxes of $223.21, and depreciation of $31,617.89, gave the taxpayer business deductions

> for that year in the aggregate sum of $144,140.33. His net loss attributable to *the operations of his above business* for that taxable year was $110,-578.05." (Italics inserted)

This is almost a literal quotation from the lower court's finding No. XIII (Tr. 75). Appellants do not object to any part of this finding except "in respect" of the italicized words (Br. 10, fn. 8). The part of finding XIII not objected to stands as a clear admission that the taxpayer was in some business, and as hereinbefore pointed out as long as he was in any business that qualified him for the full amount of a carry-back. Furthermore, the appellants do not object to the finding that the taxpayer took business deductions for the year 1945 "in the sum of $17,217.72, about which there is no dispute". Consequently, this also stands as an admission that the taxpayer was in some business during that year, and as far as the record shows the only one he could have been engaged in was the one described in the findings (Tr. 68).

B. Where the taxpayer makes advances which are an incident to his main business of acquiring, owning, expanding, equipping, and leasing food processing plants, and such advances subsequently become worthless, they must be taken into account in computing the net operating loss deduction.

Appellants begin their argument concerning the bad debt phase of this case by asserting "that the taxpayer has the burden of establishing" that "the guaranteed

corporate obligations and accrued rentals represented bad debts and not contributions to capital" (Br. 32). The lower court found that the "sums owned to plaintiff by the corporations were unpaid balances on open accounts receivable of plaintiff, . . . and were and are debts which arose in the course of plaintiff's said business and were not contributions to the capital of said corporations or to the capital of either of them" (Tr. 72). Consequently the appellants are again inaccurate in their contentions. Under the doctrine of *Augustine v. Bowles, supra,* the burden of establishing that this finding is erroneous rests on the appellants.

In order to come within Section 122 of the Internal Revenue Code (28 U.S.C.A. Sec. 122) it is only necessary for the taxpayer to sustain an excess of losses allowable as deductions by Chapter 1 of the Internal Revenue Code over gross income, with the exceptions, etc. provided in sub-section (d). Section 23 (k) (1) provides for the allowance of such a deduction in the case of business bad debts incurred by an individual. The appellants in their brief have made much of the qualification set out in sub-section (d) (5) of Section 122, and have interpreted it as placing the burden upon the taxpayer of showing that the losses claimed were "attributable to the operation of a trade or business regularly carried on by the taxpayer". It is sufficient to point out that Section 122 (d) (5) is merely a qualification that applies in case the deductions involved are *not* attributable to business activities. Since by its terms Section 23 (k) (1) applies primarily to debts, the worthlessness of which is incurred in trade or business, it is necessary

to consider only the interpretation of the latter section. The qualification of Section 122 (d) (5) may be disregarded in so far as an interpretive standard is necessary to an understanding of bad debts.[2]

The application of Section 23 (k) (1) is such that the worthlessness of any debts claimed as deductions must have been incurred in a trade or business of the taxpayer. A showing that they became worthless as a circumstance in a trade or business of the taxpayer is sufficient to qualify the taxpayer for the deduction. The Senate Finance Committee Report on the 1942 Revenue Act (5 Mertens, Law of Federal Income Taxation, 1948 Supp. p. 259) in part says:

> "The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which borrowed funds are put by the debtor, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is *not* a non-business debt for the purposes of this amendment." (Italics inserted)

This language has been incorporated verbatim into

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[2]The record shows and tha lower court found that the bad debts involved in this were "attributable to the operation of said business [of acquiring, owning, expanding, equipping and leasing of food processing plants . . . for profit (Tr. 68)] regularly carried on by the plaintiff" (Tr. 72); and the lower court concluded that the taxpayer incurred a loss in his said business from the worthlessness of said debts within the meaning of Sec. 23 (k) and was entitled to a net operating loss carry-back within the meaning of Sec. 122. In view of this appellee will not belabor the point about which Section controls, as taxpayer's loss comes well within both of them. The distinction was mentioned only because appellee does not wish through silence to give the appearance of acquiescing in what she regards as an unwarranted interpretation of Sec. 122.

Treasury Regulation 111, Section 29.23 (k)-6. The examples which are included in the regulation make it clear that it is necessary only that at the time the debt becomes worthless it be a "proximate incident" of the trade or business in which the taxpayer is then engaged.

CASES INTERPRETING SECTION 23 (k)

An application of Section 23 (k) is found in *Robert Cluett, 3rd,* 8 T.C. 1178 (1947). The petitioner was a member of the New York Stock Exchange. In 1929 the membership was increased one quarter, and each member was given the right to transfer his proportionate part of an additional membership. The petitioner sold the one-fourth of a membership to which he was entitled but was never paid, and the debt resulting from the transaction became worthless in 1943. At that time the petitioner was still a member of the Exchange.

The contention of the Commissioner was that the petitioner was not regularly engaged in the business of buying and selling seats on the Exchange, and that the bad debt was a non-business bad debt. The court sustained the contention of the taxpayer that the loss resulted directly from the operation of a business in which the taxpayer was engaged both at the time the debt arose and at the time it became worthless. The court said:

> "The debt . . . was closely related to the business of owning and using a stock exchange membership for the production of income, in which business the petitioner was engaged not only in 1929, when the debt was created, but also in 1943 when it became

> worthless. . . . That debt arose in the course of the petitioner's business, which involved owning the Exchange membership, which, in turn, required a sale of the accretion in order to realize any benefit therefrom. He was still engaged in that same business in 1943 when the debt became worthless. Thus, the debt, at all times material hereto, bore a proximate relation to the business of the petitioner and the loss from its worthlessness also bore a proximate relationship to that business."

The only other case appellee has been able to find interpreting the business necessity aspect of Section 23 (k) added by the 1942 amendment is *Vincent C. Campbell,* P-H T.C. par. 11.61 (1948). In that case a bad debt deduction was claimed for losses resulting from advances on open account to a corporation. The debts became worthless in 1944. It was the practice of the petitioners to organize, own, and operate corporations engaged in the retail coal business. The advances which became worthless were incurred in this business of organizing and operating corporations engaged in the retail coal business. The court sustained the contention of petitioners and allowed the deduction on the ground that these debts "had a direct connection with the business carried on by these petitioners", and were the result of carrying on that business.

As determined by the court below, in the case at bar, the activities which constituted the business of the taxpayer were acquiring, owning, expanding, equipping, and leasing food processing plants, and (as an incident thereto) providing for the adequate financing of the operations of those plants. The court found that the taxpayer

was engaged in those activities during the taxable years ending February 29, 1944, and February 28, 1945 (Tr. 68), that is, when the obligations for which the bad debts are claimed arose, and when they subsequently became worthless. Whether the taxpayer was or was not engaged in the business of financing canneries is of no moment. It is significant only that the taxpayer was engaged in some business, and the court below so found. The debt arose in the course of that business, and they became worthless therein. They were a proximate incident of the business of the taxpayer.

No doubt influenced by *Dalton v. Bowers, supra,* and *Burnet v. Clark, supra,* the appellants have repeatedly pressed the argument that for appellee to succeed in this case she must show that the taxpayer was in the business of financing canneries generally. The attempt to portray the taxpayer as coming within the very narrow holdings of these two cases has resulted in appellants' insistence that the taxpayer must have been engaged in a business whose main element or characteristic was performance of acts *identical* to those which gave rise to the debts owing from the corporations to the taxpayer. The necessity for "worthlessness incurred in trade or business" was first made a part of the Internal Revenue Code in 1942. "Incurred in trade or business" does not call for *identity* of the debt-yielding acts of the taxpayer with the dominant acts of his trade or business. Regulation 111, Sec. 29.23 (k)-6 promulgated by the Commissioner as a guide to the interpretation of Sec. 23 (k), and the *Cluett* and *Campbell* cases,

supra, show that the acts which produce the debts may be dissimilar from the principal functions of the business as long as they are an "incident" of that business. The *Dalton* case and the *Burnet* case, decided in 1932, were not concerned with this problem. Their holdings are limited to whether or not the particular taxpayers there involved were carrying on a business and do not treat of bad debts as outlined in Sec. 23 (k).

C. Whether advances of the taxpayer represent obligations owed to him is primarily a matter of intent.

The court below found as a fact the Dehydrator corporation owed the plaintiff $61,115.48 on account of accounts payable of said corporation which the taxpayer had previously guaranteed and did pay, and on account of notes payable to said corporation upon which the taxpayer was surety and which he did pay, and the Yakima corporation owed the taxpayer the sum of $33,966.02 on account of unpaid rent, sums advanced by the taxpayer to said corporation to pay promissory notes of said corporation upon which he was surety and which sums were used by the corporation to pay said notes, lug boxes rented to said corporation by taxpayer and not returned by it to him because they had become broken, and money belonging to him and collected by said corporation, but not paid over to him by it. The court also found that *said sums owed to the plaintiff by the corporation were unpaid balances on open accounts receivable of the plaintiff* and were debts which arose

in the course of the plaintiff's said business and were not contributions to the capital of said corporation or to the capital of either of them (Tr. 71, 72).

During his opening statement counsel for the appellants said:

> "There are no serious factual questions here involved. (Tr. 108).
>
> . . . . .
>
> "The facts here as to the amount of income and the amount of obligations paid are not in dispute at all, or, in any event, in a very minor way, . . ." (Tr. 109).

Apparently the portion of the above mentioned findings which we have italicized are the only part thereof questioned by the appellants (Br. 3, bottom of page; 5, fn. 3; 7, fn. 6; 12 and 13, points 2, 4). They do not question the fact that the sums mentioned were on open account balances as therein stated. In fact they virtually concede this by saying:

> "It clearly is not important, we submit, that some of the items were carried on the corporations' books as debts due from them to the taxpayer (R. 104-105, 142-144), and that some of the obligations constituted unpaid and accrued rentals (R. 104, 124, 163), the entries of such transactions being merely evidential and not conclusive." (Br. 34).

The capital stock of the Lebanon corporation and the Yakima corporation was in the sum of $10,000.00 each, and that of the Dehydrator corporation was $5,000.00 (Tr. 145, 186, 200). This was paid for by turning over growers' contracts to the corporations (Tr. 185). Those

turned over to the Yakima corporation, as stated, were in a value in excess of $10,000.00, and those turned over to Dehydrator corporation were of a value excess of $5,000.00 (Tr. 147). The growers' contracts were carried on the corporation's books at amounts equal to the capital stock (Tr. 186, 200).

There is not the slightest evidence that taxpayer intended to contribute anything to the capital of the corporations beyond the growers' contracts, and he testified that he at no time contributed or intended to contribute any capital to any of the said corporations other than said contracts (Tr. 148).

There is no account in the books anywhere, either of the corporation or of the taxpayer, showing any contribution to capital other than the growers' contracts (Tr. 186), and there was no money or anything else that went into any capital account or any account like a capital account, other than the growers' contracts (Tr. 189). The growers' contracts were accepted by the directors of the corporation in full payment of the capital stock (Tr. 193). It is incumbent upon the appellants to point out wherein the evidence fails to support the above finding, and this we respectfully submit they have not done. Inasmuch as there is substantial evidence to support the findings they should not be set aside on appeal. See pages 8 and 9 hereof.

A loan or an advance in order to qualify for the bad debt deduction must actually create the relationship of debtor and creditor. Whether it does is primarily a matter of intent. *Van Clief v. Helvering,* 135 F. 2d 254

(App. D.C., 1943); *Fairbanks, Morse & Co. v. Harrison,* 63 F. Supp. 495 (Ill., 1945); *Glenmore Distilleries Co., Inc.,* 47 B.T.A. 213 (1942); *Edward Katzinger Co.,* 44 B.T.A. 533 (1941); *Harry T. Nicolai,* 42 B.T.A. 899 (1940); *Daniel Gimbel,* 36 B.T.A. 539 (1937); *Lucia Chase Ewing,* P-H T.C. Memo. Dec. Par. 46,235 (1946).

In the *Fairbanks, Morse* case, *supra,* the taxpayer had purchased all of the capital stock of another corporation. As part of the purchase agreement the taxpayer became obligated to provide the subsidiary corporation with necessary working capital by way of intercompany loans or advances on open accounts from the taxpayer to or for the subsidiary; or at the option of the taxpayer by purchasing additional capital stock of the subsidiary. In holding the advances to be deductible, the court stated:

> "Whether the funds advanced by the plaintiff as the sole owner of the stock of Home Appliances, Inc., were loans or contributions to capital depends entirely upon the circumstances under which they were made. Such advances would be additional contributions to capital only if they had been intended to enlarge the stock investment and had not been intended as loans. *Edward Katzinger Company v. Commissioner,* 44 B.T.A. 533. Here the parties intended these advances as loans. This is shown by the character of the transactions. The plaintiff carried on its books an open account with Home Appliances, Inc. In this account the payments and advances were charged to the subsidiary and remittances were credited to the account. The plaintiff did not purchase any additional capital stock of the subsidiary. The contract whereby plaintiff acquired the stock of the subsidiary provided that advances made by the plaintiff should

> be in the form of inter-company loans or advances on open account unless plaintiff purchased additional capital stock of the subsidiary."

Lucia Chase Ewing, supra, was a case in which a danseuse exhibited her enthusiasm for her art by advancing some $300,000.00 to an incorporated ballet group of which she was the sole stockholder. In sustaining the claimed deduction the court based its decision on the intent standard of the *Katzinger* case, *supra,* saying:

> "In judging whether or not these advancements by the taxpayer were loans on the one hand, or gifts or advancements to capital on the other, the whole criterion set forth in the cases is as to whether or not the person making the advancements considered them to be loans and expected them to be repaid. . .
>
> "In the case at bar the taxpayer testified that she expected to be repaid; that her expectations were based upon the ultimate 'success' of the company; and, from the whole record, it is shown that she had an over abundance of confidence in that ultimate success. The balance sheets of the corporation show that these advances by the taxpayer were treated by the corporation as loans."

Nor is the purpose for which the loans are made material. It is sufficient that they be made with the intent of obtaining repayment, that is, creating a debt. In the *Van Clief* case, *supra,* the sole stockholder of a corporation advanced almost $100,000.00 to it for the sole purpose of sustaining its operations during financial difficulties. In answering the contention of the Commissioner that such advances represented capital contributions rather than loans, the court stated:

> "The inference that a loan was intended is the natural and logical inference, and the fact that Van Clief was the sole stockholder of the corporation did not tend to rebut it . . . . The fact that Van Clief made the advances to keep the corporation afloat rather than to liquidate it, has no tendency to show that a voluntary addition to capital rather than a loan was intended."

A similar situation and decision is presented by *John J. Quinn,* P-H T.C. Memo. Dec. Par. 46,254 (1946).

It is obvious from the way in which the transactions were handled in the case at bar that all advancements were intended as loans and not in any sense as contributions to capital. The Board in sustaining a bad debt deduction in *Ethel S. White,* P-H T.C. Memo. Dec. Par. 47,262 (1947), stated:

> "That sums advanced by petitioner to the paving corporations were regarded by all the parties concerned as debts and not donations is established by the books of petitioner as well as the books of the two paving corporations."

The Board virtually repeats this language in refuting the contention that because the petitioner was the principal stockholder the advances should have been considered to be capital contributions. The *Van Clief* and *Katzinger* cases, *supra,* are similar in their reliance on book entries. By the leases the taxpayer undertook to make the advances only "when required", and he testified that he thought the corporations could get credit on their own (Tr. 161, 162). Expectation of repayment was obviously based upon the expected success of the corporations. This was reasonable in view of war created

demands. The Lebanon corporation fulfilled the taxpayer's optimism (Tr. 119). That the advances secured by the taxpayer's guarantees were not capital contributions is, perhaps, most vividly acclaimed by the fact that such amounts represent obligations incurred by the corporation in the normal course of business for "operating expenses" (Tr. 197). It is common knowledge that most businesses defray current expenses with borrowed funds. This manner of financing has not the concept of permanent investment which the appellants would imply from the dealings.

COMMENTS ON ARGUMENTS OF AND CASES CITED BY APPELLANTS

The appellants have cited *Janeway v. Commissioner,* 147 F. 2d 602 (C.C.A. 2d, 1945) and *Cohen v. Commissioner,* 148 F. 2d 336 (C.C.A. 2d, 1945), for the proposition that the advances represented capital contributions. The basic factor upon which these cases are grounded is that there is no identification or clear separation of capital from debt. Under such circumstances there naturally can be no proof of an intent that advances should represent debts. In the *Janeway* case, for example, the various participants at one time or another made advances to the corporation for which they received notes. As shown by the report of this case in 2 T.C. 197, 202 (1943), for every $1,000.00 of notes there was issued 6/10ths of a share of stock. The entire stock issue was but 22.8 shares. Petitioner contended the stock was issued as a bonus. The Tax Court at page 202 said:

". . . we can not hold the stock, although issued in small quantities, to be a mere bonus, of no consequence to the present question; for the fact that the stock was issued in small quantities is immaterial, since the entire stock issue was only 22.8 shares.

. . . . .

". . . when they received the notes and stock they received pro rata control of the corporation through ownership of its stock in proportion to the amount of money advanced. Had the corporation earned large amounts of money, the petitioners would have been entitled to the whole thereof, that is, in accordance with their portion of the 22.8 shares of stock extant . . . they did receive with the other stockholders in like position as to advancements, the entire issued capital stock of the corporation and all the control and value it entailed, *in proportion to the money which went into the corporation.*" (Italics inserted)

Since the entire capital of the corporation had its basis in these so-called loans, and since all stock was issued in direct proportion to the loans so that the holders would share in the control and profits in proportion to the loans it is obvious that there was no *segregation* of capital from debt. Under such circumstances it was clear that the stock was in fact issued for the advances. The advances, then, could represent only capital.

In connection with that case, the quotation which the appellant has taken from the case should be amplified so as not to be misleading due to its inadequacy. The appellants in their brief (p. 36) quoted as follows:

"Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than

> the business and its possible success. No other money was paid in for stock, so that the advances constituted the corporation's only source of working capital."

Immediately following this excerpt, the court went on to say:

> "Ordinarily a loan to a corporation, if not otherwise secured, has the assurance of capital having been paid into the corporation so that the assets purchased therewith are subject to the payment of the loan. Here the 'loans' constituted *the sole capital,* with no other assets subject to repayment. The effect of what was done is the same as if the petitioners and the other stockholders purchased the stock with the money advanced, and became pro rata owners of the corporation." (Italics inserted)

In the case at bar, as hereinbefore indicated, growers' contracts of a value equal to that of the capital stock of the corporations were paid to corporations for their stock. The testimony shows that the corporations could not have functioned without the growers' contracts (Tr. 146). If the stock had been paid for with money, the corporations would have been justified in using the money to acquire growers' contracts, that is, of course, if they had been able to find contracts that could have been purchased—for without them there could have been no operations. There was no link of any kind between the taxpayer's advances and the growers' contracts or the amount of stock issued.

Where there are no such exceptional circumstances as existed in the *Janeway* case, *supra,* or where there is

no evidence which contradicts the conclusions stemming from the form of the transaction, the payments are considered to be loans, regardless of the fact that the contributor was also a stockholder. *Van Clief v. Helvering, supra; William D. P. Jarvis,* 43 B.T.A. 439 (1941). The appellants have pointed to the fact (Br. 36) that the advances were at the "risk of the businesses", but it is a truism that advances made by anyone to a concern are at the risk of the business.

The appellants have made further reference to *Dalton v. Bowers, supra* (Br. 35). While their statement about the case is accurate, the quotation respecting the "loss", immediately following the statement that the taxpayer "paid the debts of the corporation", may leave the impression that the loss was derived from the taxpayer's payment of the corporation's debts. This, of course, was not the case. The loss in question there was a stock loss. It is true that the taxpayer paid the debts of the corporation, and when they became worthless debts in 1923 and 1924 he claimed the statutory deduction. For aught that appears the bad debt was allowed.

The only other cases which appellants cite as support for the statement they make at the top of page 35 of their brief are *Burnet v. Clark, supra,* hereinbefore discussed, and the two following cases.

American Cigar Co. v. Commissioner, 66 F. 2d 425 (C.C.A. 2d, 1933), was a case in which the taxpayer advanced funds to a corporation in which the taxpayer was a stockholder, knowing at the time it advanced the funds that they would never be repaid and that any

obligations created thereby were worthless and uncollectible. The court held that such advances, made with no intent of repayment, were gifts or contributions to capital. From what has already been said it is obvious that in the case at bar there was reasonable expectation that the corporations would be able to pay their obligations, which the taxpayer guaranteed.

Corn Exchange National Bank & Trust Co., 46 B.T.A. 1107 (1942), is completely inapposite. The situation there was one in which the taxpayer undertook to pay all liabilities to creditors of another bank in exchange for all the assets of the latter. On the assets transferred to the taxpayer, the latter realized an amount less than the liabilities it had assumed. The question presented was whether the relation of debtor and creditor existed between the taxpayer and the other bank, so that it might claim the loss sustained on the sale of the assets transferred to it as a bad debt. The Board held that there was no such relation, saying:

> "Under the stipulated facts all obligations of Union and its stockholders to Corn Exchange ceased when the latter took over Union's assets and assumed its liabilities."

The following suggestion is made by appellant (Br. p. 37):

> "The taxpayer's arrangement under the leases with his three cannery corporations whereby he furnished all the working capital (R. 104, 123, 157, 159) and eventually, upon their liquidation, withstood all the resulting losses, might well be considered to have constituted payments made under

> the contracts indemnifying the corporations against losses on their notes, . . ."

That shows a misconception of the facts. The "financing" clause of each lease was an undertaking of the taxpayer to assist in financing when required, and was not an undertaking whereby he agreed to insure the corporations against loss on their future operations. The obligation which the taxpayer assumed under the lease was independent of loss and would have been binding in the absence of loss. The controlling detail is the manner whereby the taxpayer fulfilled the obligation which he had thus assumed, and the court found that he did this by guarantee and as a surety. The court found that the Dehydrator corporation owed the plaintiff the sum of $61,115.48 on account of accounts payable of said corporation, which plaintiff had previously guaranteed and did pay, and on account of notes payable of said corporation, upon which the plaintiff was surety and which the plaintiff did pay, and that the Yakima corporation owed the plaintiff the sum of $33,966.02 on account of, among other things, sums advanced by the plaintiff to said corporation to pay promissory notes of said corporation upon which plaintiff was surety and which sums were used by it to pay said notes (Tr. 71-72). It must be stated flatly that by no exercise of the imagination is it possible to stretch a contract of guarantee into a contract of indemnification. The cases which appellants cite at the bottom of page 37 of their brief with the exception of *Howell v. Commissioner,* 69 F. 2d 447 (C.C.A. 8th, 1934), do not even deal with the problem of indemnification. The *Howell* case while correctly

summarized is also not pertinent to this argument, as we have just pointed out, because there is no contract of indemnification involved here.

Near the top of page 18 of their brief appellants say that the net operating losses are alleged to have been suffered because of the taxpayer's guarantees to pay obligations of the corporations. Those losses were suffered because two of the three corporations failed to make sufficient profits to pay their obligations. It was only because of the failures of two of the corporations that taxpayer was called upon to satisfy their obligations that he had guaranteed. Had these two corporations been successful they could have been able to pay their debts.

At page 18 of their brief appellants say that upon liquidation (of the corporations) the taxpayer satisfied their outstanding obligations and it is this amount and the advancements which he claims as a carry-back loss. This is true as far as it goes, but overlooks the fact that the outstanding obligations were satisfied by the taxpayer only because of his pre-existing guarantees.

The appellants have sought to distinguish the *Katzinger* case, *supra,* by pointing out that the Board refused to allow deductions on the same loss for both the years 1933 and 1936. Lest there be any doubt, however, that the Board found a bad debt (although it allowed only a portion thereof due to the prior deduction taken in 1933), the following portion of its opinion is quoted:

> "The respondent argues that all of the funds advanced by the petitioner must be regarded as ad-

ditional capital contributions since Bruce-Hunt had to have more than $1,000 with which to conduct its operations. He cites no authority in support of this argument and we know of none. Funds advanced by shareholders to their corporation may or may not be contributions of capital, augmenting the cost of the shares, depending upon the circumstances under which the advancements are made. Advances are an additional contribution of capital if they are intended to enlarge the stock investment, but not if they are intended as a loan. . . . We hold that the petitioner sustained a loss of $28,950.06 from a debt which it ascertained to be worthless and charged off in 1936."

CONCLUSION

The findings of fact and conclusions of law of the District Court are correct, and the judgment of the District Court should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

Sec. 23. Deduction from Gross Income.

In computing net income there shall be allowed as deductions:

. . . . .

(k) Bad Debts.

(1) General Rule. Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

. . . . .

(4) Non-Business Debts. In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

. . . . .

(s) Net Operating Loss Deduction. For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under Section 122.

Sec. 122. Net Operating Loss Deduction.

(a) Definition of Net Operating Loss. As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) Amount of Carry-Back and Carry-Over.

(1) Net Operating Loss Carry-Back. If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

. . . . .

(d) Exceptions, Additions, and Limitations. The exceptions, additions, and limitations referred to in subsection (a), (b), and (c) shall be as follows:

. . . . .

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.